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EX PARTE OR LATE FILED

August 19, 1997

By Messenger

William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W. - Room 222
Washington, DC 20554

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AUG 19 1997

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Re: EX PARTE
Docket WB 97-82;
Public Notice DA 97-1152

Dear Mr. Caton:

At the request of the Wireless Telecommunications Bureau, I am submitting in the above-captioned docket the attached letter requesting a ruling on the application of the designated entity rules, Section 24.709 (b)(7) of the Commission rules. The attached letter was the focus of discussion during a meeting today between the following representatives of the Wireless Telecommunications Bureau: Rosalind Allen, Kathleen O'Brien-Ham, Jerome Fowlkes, D'wana Terry, and Diane Conley. Also in attendance at today's meeting were the following: on behalf of Siemens Coporation, Arthur Hayes and Cheryl Tritt of Morrison & Foerster LLP; and on behalf of DiGiPH Communications, Inc., Michael Kurtis of Kurtis & Associates, P.C.

Pursuant to § 1.1206 of the Commission's rules, 47.C.F.R. § 1.1206, an original and one copy of this letter are being submitted to the Office of the Secretary for inclusion in the public record. Please direct any questions or concerns to the undersigned.

Very truly yours,

Michael K. Kurtis jmr

Michael K. Kurtis

cc: Rosalind Allen
Kathleen O'Brien-Ham
Jerome Fowlkes
D'wana Terry
Diane Conley

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May 1, 1997

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2025 M Street, N.W. - Room 5002
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TELECOMMUNICATIONS

Re: Request for Letter Ruling Regarding Application of Designated Entity Rules--
§ 24.709(b)(7)--and Foreign Ownership Rules

Dear Mr. Phythyon:

This letter requests confirmation that a proposed modification to a financing arrangement contemplated between a Lender and an Entrepreneurs' Block ("C Block") Personal Communications Service ("PCS") licensee (the "Licensee") complies with FCC designated entity rules regarding small business licensees. Specifically, the parties request a determination that affording, under certain circumstances, limited, contingent rights of conversion in respect of certain notes held by a lender (the "Lender") would not result in those notes being considered on a fully diluted basis pursuant to Section 24.709(b)(7) of the Commission's rules.¹ The parties also request confirmation that in affording such limited and contingent rights, the Licensee's corporate structure would continue to comply with Sections 310(b)(3) and (b)(4) of the Communications Act of 1934, as amended.

Background

The Licensee has obtained significant vendor financing in order to construct its PCS system in conformance with FCC build out requirements. The Licensee is structured pursuant to the Commission's 49.9 percent equity exception for C Block licensees.² The Lender, a foreign manufacturer, has provided financing to the Licensee via six separate, secured debt instruments. The first three debt instruments are convertible notes. The sixth

¹ See 47 C.F.R. § 24.709(b)(7).

² See 47 C.F.R. § 24.709(b)(5).

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debt instrument is not convertible, and evidences a secured loan for the purchase and installation of the Licensee's PCS network. Notes four and five, the subject of this request, include conversion rights. However, the Lender has agreed to reduce the interest rates associated with those two notes if the Lender could be afforded rights of conversion under the limited circumstances set forth below. Under both the current convertible notes as well as under the proposed contingent conversion rights proposed herein, the Lender is, and would remain, solely a passive investor and would not participate in the management, operations or other affairs of the Licensee.

The initial note (the "First Note") provides for conversion at the Lender's option to non-voting common stock equaling 20 percent of the equity of the parent company (the "Parent") that holds a 100% interest in the Licensee (80% after conversion of the Third Note, as described below). The second note (the "Second Note") provides for conversion at the Lender's option to non-voting common stock equaling 5 percent of the equity of the Parent. The First and Second Notes in the aggregate give the Lender a 20% indirect equity interest in the Licensee. $[.80 \times .25 = .20]$. The third note (the "Third Note") is convertible at the Lender's option to non-voting common stock representing a direct 20 percent equity holding in the Licensee. Under Section 24.709(b)(7) of the Commission's rules, the parties assume that these first three debt instruments will be treated as fully diluted.

As proposed herein, the fourth note (the "Fourth Note")³ would carry contingent conversion rights which would vest only in the event that the Lender first assigns or transfers all interest in the First and Second Note to a qualified unaffiliated third party and/or receives an additional letter ruling or other written determination from the FCC that its rules and regulations permit the Fourth Note to be converted without such assignment, based upon the law and applicable facts at the time. Thereafter, the Fourth Note would be convertible at the Lender's option, contingent upon its ability to do so in compliance with all applicable requirements of law (including foreign ownership and C-Block ownership rules), to non-voting stock equal to 25 percent of the total equity of the Parent. The fifth note ("Fifth Note"), like the Fourth Note, would carry conversion rights only in the event that the Lender first assigns or transfers all interest in the First and Second Notes to a qualified, unaffiliated third party and/or receives a letter ruling or other written determination from the FCC that,

³ Under the terms of the Fourth Note and the Fifth Note, interest presently accrues at the London InterBank offered rate ("Eurodollar Rate") plus 8.5% per annum. Lender has agreed to reduce such interest rate to the Eurodollar Rate plus 4.5% per annum on the date on which the undersigned receive a ruling from the FCC that the Fourth and Fifth Notes could become convertible if such conversion rights were contingent upon (i) the assignment of the First Note and the Second Note (or the shares receivable upon conversion thereof) or (ii) FCC approval without such an assignment). Such is the letter ruling sought herein.

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under applicable law, the Fifth Note may be converted. Thereafter, and only if it may do so in compliance with all applicable requirements of law (including foreign and C-Block ownership rules), the Fifth Note would be convertible at the Lender's option to non-voting stock equal to 5.75 percent of the total equity of the Parent.⁴

In sum, the conversion of the Fourth and Fifth Notes would be conditioned upon (i) the prior assignment of the First and Second Notes (or the stock received upon conversion thereof) by the Lender to an unaffiliated third-party which could be a member of the control group, or (ii) upon FCC approval of the conversion of the Fourth and Fifth Notes without the assignment of the First and Second Notes (including approval of a greater than 25 percent indirect foreign interest in the Licensee). Such assignment, if completed prior to five years after the initial grant of the C Block license, would either be structured to ensure that the Licensee's control group maintained the necessary 50.1 percent total equity interest in and control of the Licensee, or the Lender and the Licensee would seek prior FCC approval of a control group total equity of less than 50.1 percent.

Under this debt structure, the Lender at no time will exercise either *de facto* or *de jure* control over the Licensee. The Licensee's control group, at all times, will hold and vote at least 50.1 percent of the voting stock of the Licensee and will constitute or appoint more than 50 percent of the board of directors,⁵ will have the authority to appoint, promote, demote and fire senior executives that control the day-to-day activities of the Licensee, and will play an integral role in all major management decisions of the Licensee.⁶ Accordingly, the Lender and Licensee seek Commission confirmation that with the contingencies and limitations as described above, neither the Fourth Note nor the Fifth Note would be considered fully diluted until or unless they are converted to an equity interest.

⁴ If the Lender were to convert both the Fourth and Fifth Note, it would hold a 32.75% non-voting equity position in the Parent. However, as set forth above, any conversion of either of the Fourth Note or the Fifth Note would be expressly contingent upon continued compliance with all applicable FCC Rules, including without limitation, the foreign ownership and C-Block auction eligibility rules. The Lender would therefore seek an FCC finding that any equity holding above 25% is in the public interest prior to its being allowed to proceed with any such conversion.

⁵ In fact, under the contemplated structure, the Licensee's control group will hold and vote 100% of the voting stock of the Licensee and will constitute or appoint 100% of its board of directors.

⁶ See *Implementation of Section 309(j) of the Communications Act - Competitive Bidding*, 10 FCC Rcd 403, 447 (1994).

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As discussed more fully below, the parties also assume that this debt arrangement complies with Sections 310(b)(3) and (4) of the Communications Act of 1934, as amended.⁷

Discussion

In an effort to ensure that C Block licensees are controlled by entities eligible to hold C Block licenses, Section 24.709(b)(7) of the Commission's rules provides that all ownership interests in a designated entity generally will be calculated on a fully diluted basis.⁸ Accordingly, "all agreements such as warrants, stock options and convertible debentures will *generally* be treated as if the rights thereunder already have been fully exercised..."⁹ The Commission has recognized, however, that the C Block participants face serious financing challenges as they attempt to compete with much larger, better capitalized mobile service providers, and has stressed that its rules are not intended to unduly restrict C Block licensees' ability to secure adequate financing.¹⁰ As the Commission examines designated entities' financing arrangements, it must balance a Licensee's need to facilitate debt acquisition and investment with a reasonable application of its rules.

Commission Rules And Precedent Support A Finding That The Fourth And Fifth Notes Should Not Be Considered Fully Diluted

The modification of the debt arrangement contemplated by the Lender and the Licensee does not raise any of the transfer of control issues that are at the heart of the Commission's rules regarding designated entity eligibility. There is no question that the conditions of the First, Second and Third Notes comply with even a strict application of Commission rules. Moreover, the Fourth and Fifth Notes would become convertible only under circumstances meeting the Commission's control group equity requirements, or pursuant to FCC approval. At no time would the Lender hold an impermissible equity interest in the Licensee pursuant to Commission rules. Thus, under this financing arrangement there are no means by which the Lender can improperly assume control of the Licensee and its PCS operations.

⁷ See *Request by Data Transmission Co. for a Declaratory Ruling Concerning Alien Ownership*, 52 FCC 2d 439 (1975) ("Data Transmission").

⁸ See 47 C.F.R. § 24.709(b)(7).

⁹ *Id.* (emphasis added).

¹⁰ See *Implementation of Section 309(j) of the Communications Act – Competitive Bidding*, 9 FCC Rcd 2348, 2396-97 (1994) ("Second R&O").

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Moreover, Section 24.709(b)(7) states that interests such as convertible debt *generally* will be treated as fully diluted. The inclusion of the word "generally" clearly indicates that the Commission intended the rule to be sufficiently flexible to permit the kind of arrangement presented here. The underlying rationale for the rule is simply not at issue.¹¹ and blind application of the rule would deny the Licensee a *significantly* lower interest rate and associated preservation of limited capital; capital that could be available for further construction, enhancements and greater working capital. Application of the rule in this case, therefore, does not advance the underlying rationale for the restriction and represents the kind of unnecessary regulatory activity that the Commission has sought to eliminate in numerous areas, particularly in its oversight of commercial mobile radio services.

A more flexible approach to the treatment of convertible debt, which is clearly supported by Section 24.709 in this case, advances the goal of both the Congress and the Commission to ensure that small businesses have genuine opportunities to participate in the provision of PCS services.¹² In one of the several orders implementing its competitive bidding rules, the Commission stated that:

Our attribution rules are designed to preserve control of the applicant by eligible entities, yet allow investment in the applicant by entities that do not meet the size restrictions in our rules. Therefore, so long as the requirements of our attribution rules are met, the affiliation rules will not be used to defeat the underlying policy objectives of allowing such passive investors. More specifically, if a control group has *de facto* and *de jure* control of the applicant, we shall not construe the affiliation rules in a manner that causes the interests of passive investors to be attributed to the applicant.¹³

Permitting convertible debt instruments to remain nonattributable under the circumstances outlined above will provide C Block licensees with an important tool to help ensure their success. The limitations and contingencies of the conversion rights as set forth above would absolutely ensure the integrity of the Commission's rules. Accordingly, under these specific

¹¹ See *Implementation of Section 309(j) of the Communications Act - Competitive Bidding*, 9 FCC Rcd 5532; 5583 (1994) ("*Fifth R&O*"). (The Commission's attribution rules are meant to "deter shams and fronts and to prevent abuse of the incentives for designated entities.").

¹² See *Second R&O* at 2349.

¹³ *Fifth R&O* at 5620.

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circumstances and with the specific limitations and contingencies set forth above, it is respectfully submitted that the grant of the limited contingent conversion rights to the Fourth and Fifth Notes should not cause those notes to be considered fully diluted when calculating the Licensee's ownership interests.

Lender Is Solely A Passive Investor And Cannot Exercise Control

The Lender is a solely passive investor that has no ability to exercise control over the Licensee's operations. Because the Lender is a manufacturer with no telecommunications operating division, it also has no incentive to assume control of the Licensee. Rather, the Lender wishes to ensure sufficient financial return to counterbalance the risk inherent in the financing of the Licensee's operation, and any prospective economic gain will be proportionate to the Lender's economic investment. Lender has presently done so by charging Licensee a significantly higher interest rate for the Fourth and Fifth Notes. Lender has agreed to substitute the proposed contingent conversion rights for that higher interest rate as a means of counterbalancing the level of risk associated with these two Notes.

The Commission previously has recognized that a party's position as a non-voting stockholder insulates it from the kind of influence over a licensee's operations that would raise unauthorized transfer of control concerns under Commission rules. For example, in its *Attribution Order*, the Commission noted that:

non-voting stock by its specific nature precludes the means to influence or control the activities of the issuing corporation, and this relationship is knowingly and intentionally entered into by the corporation and by the stockholder.¹⁴

The availability of a nonattributable non-voting stock investment mechanism provides an "invaluable means by which existing and prospective licensees raise new capital *without diluting their control* over their companies."¹⁵

The Fourth and Fifth Notes also meet the Commission's five factor test used in assessing whether convertible debentures should be treated as debt or as capital

¹⁴ *Corporate Ownership Reporting and Disclosure by Broadcast Licensees; Reexamination of the Commission's Rules and Policies Regarding the Attribution of Ownership Interests in Broadcast, Cable Television and Newspaper Entities*, 97 FCC 2d 997, 1020 (1984) ("Attribution Order").

¹⁵ *Attribution Order* at 1020-21 (emphasis added).

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contributions.¹⁶ The factors are: "1) whether there is a written unconditional promise to repay the money on demand and to pay a fixed rate of interest; 2) whether there is subordination to or preference over any indebtedness of the company, 3) the company's debt/equity ratio; 4) whether the alleged debt is convertible to stock; and 5) the relationship between holdings of stock in the corporation and holdings of the interest in question."¹⁷

First, each of the six notes in the present financing arrangement carries a written, unconditional requirement that the loan be repaid in cash, and sets out the applicable interest rates for the loans. The debt therefore, cannot be characterized as "long-term equity" as in the recent *NextWave* order where the borrower could always pay the interest on the loan with stock rather than cash.¹⁸

Second, the Notes would be subordinated only to the first lien held by the FCC. Thus, unlike capital contributions which normally are subordinate to all corporate debt instruments, the Licensee's obligation to repay the loans is in no way linked to the success of the PCS venture.¹⁹ Further, exclusive of all debt instruments, the Licensee has been capitalized with an equity contribution in excess of fifteen million dollars (\$15,000,000) by its C Block qualified equity owners, representing a total debt to equity ratio of approximately seven to one. Attribution of the equity interest associated with the conversion rights of the first three notes would result in a debt to equity ratio of only 2.5 to 1 (3.8 to 1 including the debt owed to the FCC). Clearly, the venture is adequately capitalized without the conversion of the Fourth and Fifth Notes.

Finally, application of the fourth and fifth factors to the proposed modification of this debt financing demonstrates that the Lender does not effectively gain the benefits that would normally be reflected in corporate ownership.²⁰ The Lender has no right to vote or participate in the Licensee's daily corporate affairs and in no way exercises influence or control over the Licensee. The Lender is merely a passive non-voting investor.

¹⁶ See *Fox Television Stations, Inc.*, 11 FCC Rcd 5714, 5720 (1995).

¹⁷ *Id.*

¹⁸ *Applications of NextWave Personal Communications, Inc. for Various C-Block Broadband PCS Licenses*, 12 FCC Rcd 2030 (1997) ("*NextWave*").

¹⁹ See *id.* at 2054.

²⁰ *Id.* at 2056-60.

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Under any analysis of existing Commission rules and precedent the convertible debt mechanisms proposed by the parties are designed solely to protect the financial position of the Lender and to ensure adequate debt financing for the Licensee. The treatment of the Lender's interest in the Fourth and Fifth Notes as fully diluted is wholly unnecessary to protect the Licensee from undue influence or improper assumption of control, and does not square with the rationale advanced by the Commission for when convertible debentures should be treated as capital contributions.

Foreign Ownership Issues

The existing financing arrangement complies with the foreign ownership restrictions set forth in Sections 310(b)(3) and (4) of the Communications Act of 1934, as amended. The Commission recently clarified that convertible debt held in C Block licensees is not attributed for foreign ownership purposes until it has been converted.²¹ Upon conversion of the Third Note, the 20 percent non-voting, direct foreign investment in the Licensee and upon conversion of the First and Second Notes, the 25 percent nonvoting, direct foreign investment in the Parent as described above, would comply with the Act's foreign ownership restrictions because the two interests are not aggregated for purposes of calculating foreign ownership.²² Allowing the limited, contingent conversion rights outlined above to be granted to the Fourth and Fifth Notes would still ensure that no conversion could occur which would alter the amount of foreign ownership. On their face, the rights of conversion associated with the Fourth and Fifth Notes would require prior divestiture of any other holding which would result in a violation of the Commission's foreign ownership rules, or that the Licensee first seek a declaratory ruling from the Commission before any change in the described structure that would give the Lender more than a 25 percent indirect equity interest in the Licensee.

Conclusion

For the foregoing reasons, the undersigned respectfully submit that the proposed modification to the above-described financing arrangement would serve the public interest

²¹ *DCR PCS, Inc.*, 11 FCC Rcd 16849, 16858 (1996) ("Commission precedent is clear that with respect to foreign ownership questions, an option held by a foreigner to buy stock in a licensee or the parent of a licensee is not cognizable until it is exercised."). See also *NextWave* at 2050-51 ("We reaffirm that bona fide debt interest as well as bona fide future interests are not included in our analysis of foreign ownership interests under Section 310(b).") (footnote omitted).

²² See *Data Transmission* at 440.

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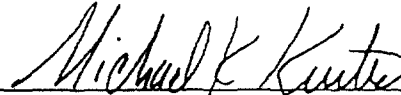
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in conformity with Commission designated entity rules and foreign ownership limitations set forth in Sections 310(b)(3) and (b)(4) of the Act and, therefore, request confirmation that such an arrangement is permissible under FCC rules.

Respectfully submitted,



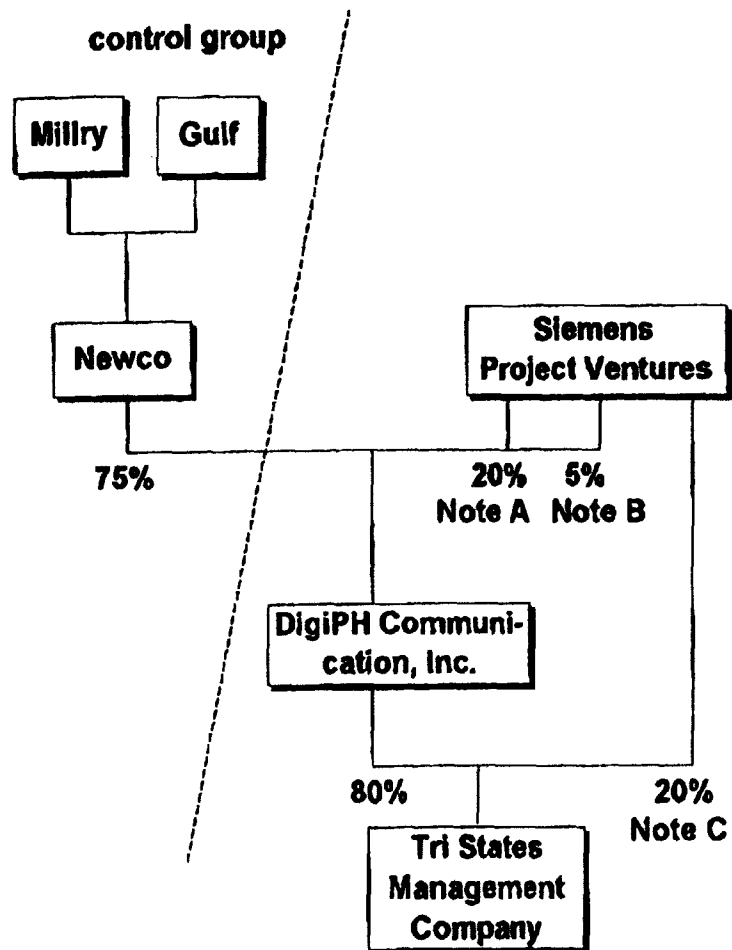
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Pre-Conversion of Notes D and E



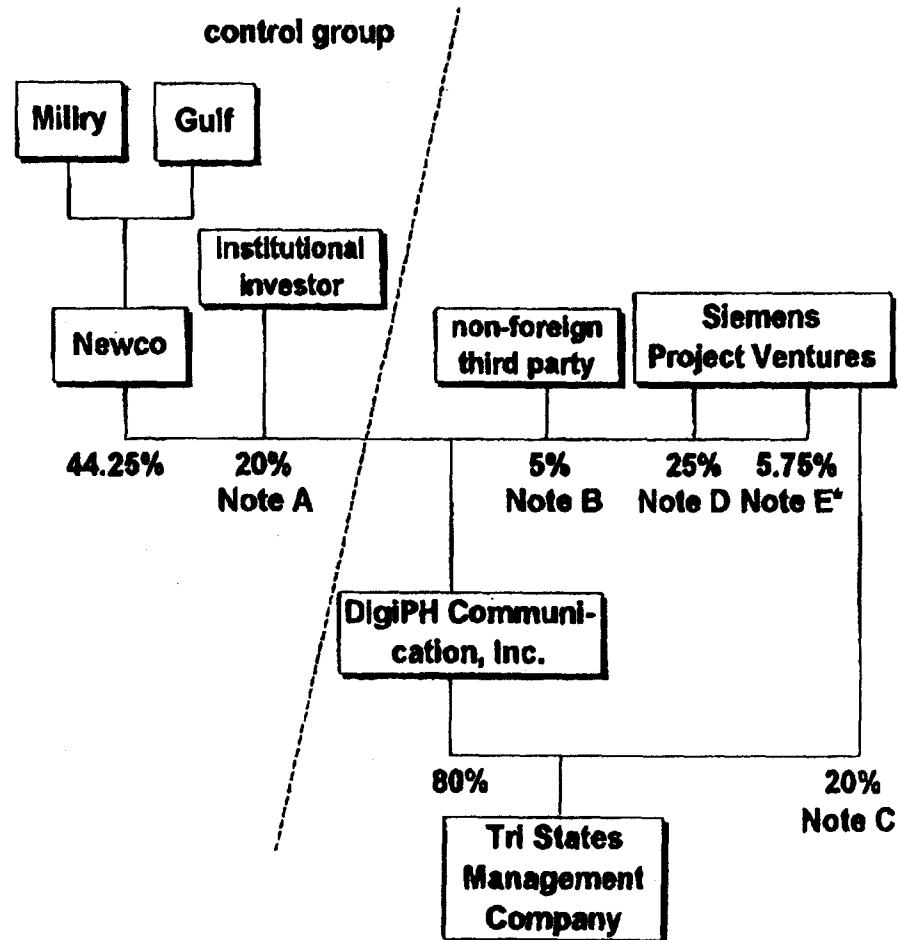
Siemens' beneficial interest in licensee if Notes A, B and C are deemed diluted.

$$(20\% + 5\%)(80\%) = 20\% (A + B)$$

$$\underline{20\% (C)}$$

$$40\%$$

Post-Conversion of Notes D and E



Siemens' beneficial interest in licensee after Notes A and B are sold and if Notes C, D and E are deemed diluted.

$$(25\% + 5.75\%)(80\%) = 24.6\% (D + E)$$

$$\underline{20.00\% (C)}$$

$$44.6\%$$

* If Note E is not deemed diluted, Siemens' beneficial interest in licensee would be 40%.